United States Court of Appeals

for the Second Circuit

SUPPLEMENTAL MEMORANDUM

74-1537

United States Court of Appeals
FOR THE SECOND CIRCUIT
DOCKET No. 74-1537

RENEE SLADE,
Plaintiff, Appellee,
against
SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff, Appellant,
against
NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

B
P/S

EDWARD E. ODETTE,
Plaintiff, Appellee,
against
SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff, Appellant,
against
NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

SUPPLEMENTAL MEMORANDUM OF DEFENDANT, THIRD-PARTY PLAINTIFF, APPELLANT

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SUPPLEMENTAL MEMORANDUM OF DEFENDANT, APPELLANT, AND THIRD-PARTY PLAINTIFF SHEARSON, HAMMILL & CO. INCORPORATED

Pursuant to Federal Rule of Appellate Procedure 29 and permission of this Court, defendant, third-party plaintiff and appellant Shearson, Hammill & Co. Incorporated ("Shearson") submits this Supplemental Memorandum in further support of its appeal and in response to the *amicus* brief recently submitted by the Securities and Exchange Commission ("Commission").

ARGUMENT

Shearson's Procedures Insure Fair Treatment of all Investors; the Commission's Do Not

All parties to the appeal agree that this Court should adopt a solution promoting maximum fairness for the entire investing public. [Shearson Br. at 23; Slade Br. at 7; Salomon Br. at 11-12; SEC Br. at 5, n. 6, and 6]. Under Shearson's procedures, no member of the investing public has an advantage over anyone else through material nonpublic information; all investors are benefitted by the most prompt possible disclosure of information even when the issuer is recalcitrant; and while the information is not public, it is confined to the smallest number of persons necessary for performance of the investment banking function, thus minimizing the risk of improper conduct. [Bogardus Aff. paras. 6-10, JA at A-27-A-28]. This Court need only determine whether Shearson's procedures constituted fraud under the federal securities laws, not whether they are the only acceptable solution to the problem or whether some other procedure might be slightly better.

The Commission urges this Court to adopt an ill-defined "restricted list" procedure under which the firm sometimes will not solicit any transactions, buy or sell, in the stock of a company whenever it *could* or does learn non-

public information about the issuer. The Commission's procedure contemplates two circumstances: the foreseeable, *e.g.,* the situation in which the investment banker adds the issuer to the list because he *might* learn nonpublic information through a planned underwriting; and the unforeseeable, *e.g.,* the situation in which the firm unexpectedly learns nonpublic information about an investment banking client.

The solution recommended by the Commission is defective for numerous reasons. First, it combines two lines of authority to produce a totally illogical result. Second, it ignores the basic concept of *overall* fairness to the investing public by requiring that some members of the investing public receive more favorable treatment than all others; that other members of the investing public receive distinctly unfair treatment; and that the firm, in practical effect, gives improper investment advice to some of its customers. Third, it ignores the reality of the relationship between an issuer and its investment banker. Fourth, it creates a potential enforcement horror. Last, it rejects the often-stated views of former members of the Commission, including two Chairmen. These points are discussed in the following pages.

First, the Commission combines two principles of law (the restriction on the use of nonpublic information and the requirement that a registered representative have a reasonable basis for recommending a security) to produce a totally illogical result. By assuming the answer to the issue before this Court, *i.e.,* that the solicitations were inconsistent with information which should have been known to the registered representatives, the Commission suggests that Shearson violated a duty of fairness to its brokerage customers because its registered representatives solicited transactions on the basis of favorable public information while unfavorable but nonpublic information was confined to its investment banking department. Of course, no case holds this. The Commission relies principally on *Hanly* v.

Securities and Exchange Commission, 415 F.2d 589 (2d Cir. 1969), urging that this opinion required Shearson's registered representatives to have "an adequate and reasonable basis for [a] recommendation." [SEC Br. at 7]. Shearson agrees with this, and in the case at hand, the publicly available information supported a solicitation. The Commission then reasons from *Hanly* that "Rule 10b-5 prohibits recommendations contrary to facts about the security in question known by the broker-dealer." [SEC Br. at 7-8]. The only basis for this conclusion is the common law principle of imputing the nonpublic information in the investment banking department to registered representatives. UCC 2-201 (27) and *Restatement (Second) of Agency* § 275, comment b and § 281 (1958). Every commentator who has considered the information isolation procedure has rejected this approach. *E.g.,* O'Boyle, *Third Annual PLI Institute on Securities Regulation* at 486 (1972). And the plain fact here is that the registered representatives did not know and could not lawfully have known the information confined to Shearson's investment banking department. [Shearson Br. at 9-17; Shearson Rep. Br. at 4-12; and SEC Br. at 4, n. 4, and 6]. The law does require the registered representative to have a reasonable basis for his solicitation; and the public has a right to expect this; but if Shearson's customers thought they were entitled to the benefits of nonpublic information, that expectation is clearly unwarranted as a matter of law. *Investors Management & Co., et al.,* Sec. Ex. Act Rel. 34-9267, CCH Fed. Sec. L. Rptr. ¶ 78,163 (1970-71 Transfer Binder) (at 80,522) (July 29, 1971); *Cady Roberts,* 40 SEC 907, 916 (1961); *see also, Kuehnert* v. *Texstar Corp.,* 412 F.2d 700 (5th Cir. 1969); and SEC Br. at 6. Nor could the securities customer reasonably anticipate that Shearson would publicize developments itself. The Commission, the courts, the exchanges, and the commentators agree that disclosure is the issuer's obligation. *Investors Management Co., supra* at 80,552; *Financial Indus. Fund, Inc.* v. *McDonnell Douglas Corp.,* 474 F.2d 514, 518 (10th Cir. 1973);

Haack, Corporate Responsibility to the Investing Public, CCH Fed. Sec. L. Rptr. ¶ 77,554 (1968-69 Transfer Binder) (at 83,171) (1968); Penn, Should Underwriters Disclose, *Wall Street Journal* at 20 (September 16, 1974); Patrick, *Perpetual Jeopardy* 132 (1972); and SEC Br. at 12.

If the purpose of the restricted list is to protect investors and preserve public confidence in the securities markets, the purpose will not be accomplished by the Commission's procedures. The investor will not differentiate between an unsolicited and a solicited trade when he learns that the firm's investment banking department had nonpublic information at the time. That is why Salomon Brothers is being sued now by unsolicited purchasers of Consolidated Edison stock, *Shapiro, et al.* v. *Consolidated Edison Co., et al.,* 74 Civ. 1906 (S.D.N.Y. 1974). And the problem is the same for banks. The beneficiaries of a pension trust are suing a large Chicago bank because the trust division of the bank bought stock for the trust when the commercial loan department had adverse nonpublic information about the company, *O'Donnell* v. *Continental Ill. Nat'l Bank & Tr. Co.,* 73 C. 772 (N.D. Ill. 1973). In neither of these cases would the Commission's procedure "protect" the customer. At best a "restricted list" will satisfy the unlawful and unjustifiable desires of a small part of the investing public by combining two sound principles of law to produce a *non sequitur.*

Second, the Commission ignores the basic concept of overall fairness to the investing public, a concept established by the Commission's own landmark result in *SEC* v. *Texas Gulf Sulphur,* 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971), *reh. denied,* 404 U.S. 1064 (1972). As shown in earlier briefs [Shearson Br. at 10-11, Salomon Br. at 11-12; and Shearson Rep. Br. at 4], both the legislative history of the Securities Exchange Act of 1934 and the decision in *Texas Gulf Sulphur, supra,* require that all members of the investing public have equal access to information, be given equal benefit of information, and be treated equally. The "restricted list" procedure advo-

cated by the Commission in its brief would grant a special benefit to a small portion of the investing public and would impose a detriment on several other segments of the investing public.

A few members of the investing public receive more favorable treatment than all others. As Shearson's main brief showed at length [Shearson Br. at 9-17], a restriction on solicitations will benefit those members of the investing public who would have purchased securities of the issuer if it were not for the restriction. Especially if the restriction is unforeseeable, the firm's customers would not buy the stock solely because the nonpublic information was used for their benefit.

Other members of the investing public would receive unfair treatment by being deprived of an opportunity to sell their securities in a fairly derived securities market. Those members of the investing public who wish to sell will be deprived of that part of the market which would have included the purchasers withdrawn by the Commission's procedure. [Shearson Br. at 8, 17].

The firm, in practical effect, will give improper investment advice to its customers. At any point in time, a security will be subject to one of three investment decisions: buy, sell, or hold. Because a restriction prohibits any solicitation, purchase or sale, the customer who would have sold but for the restriction will, in practical effect, have been advised to "hold" the security. For any of a number of reasons, a member of the investing public may desire to sell a security even if the current public information is favorable. For example, if he ought to take his profit and invest it in another security or use it for some other purpose, a restriction on solicitations will prevent the registered representative from soliciting the sale of the stock. This result is particularly likely when the investor relies on his registered representative for advice, and it is mandated when the account is handled on a discretionary or fiduciary basis.

Third, to the extent that the Commission's restricted list procedure rests on the foreseeability of receiving nonpublic information, it ignores the reality of the relationships between a company and its investment banker, a company and the bank making commercial loans to it, and a company and its institutional lenders like insurance companies. It suggests that the securities of a company be placed on a restricted list whenever the relationship between the issuer and the firm is "likely to result in the receipt of inside information—*i.e.*, before such inside information has been received." [Commission Br. at 12]. The relationships between a company and its investment banker, its commercial lender, and its institutional lender are continuous, thus providing continuous nonpublic information. [Bogardus Aff. para 5, JA at A-27]. At the same time, all three of these institutions are active in the public securities markets, the investment banker through its retail sales organizations, the commercial bank through its personal trust division, and the institutional lender (insurance company) through its portfolio management. The Commission itself has noted that these relationships are continuous and that they give continuous nonpublic information. In SEC, 1 *Special Study of the Securities Market* at 433-34, the Commission stated:

> "It should also be pointed out that underwriting firms, whether or not they have a representative on a company's board of directors, often retain a special relationship which enables them to obtain information concerning the company which the general public does not have. In the first place, the requirement in an underwriting agreement of regular financial reports to the managing underwriter, as distinguished from the general body of stockholders, may give the firm a considerable advantage in the market. Secondly, a firm with an underwriting relationship is likely to be among the first to be advised of any corporate developments. Such information may not be secret, and it may be

available to any diligent analyst who bothers to inform himself about the company, but the underwriting firm may still have a very real advantage over members of the general public. An officer of William, David & Motti, Inc., a small broker-dealer firm, now defunct, stated, with regard to companies whose securities the firm has underwritten:

> Most of the information we get does not come from the board of directors. * * * Any information we want we usually speak to the president on the phone and it has nothing to do with the directors. We would get that information whether we were a director or not. * * *
>
> Some of the information, sure, it is nonpublic information, either good or bad."

The Commission's procedure would require the firm to place these companies on its restricted lists throughout the lifetime of the relationship, an intention which both the Commission and Salomon Brothers disavow [SEC Br. at 12; Letter of Donald A. Feuerstein to A. Daniel Fusaro, dated October 23, 1974; Salomon Br. at 5]; and it necessarily deprives the customer, trust beneficiary, or insurance company shareholders of transactions in many of the best securities through its regular relationship. Of course, a secondary advisor could be used for "restricted" securities; but leaving aside the practical disabilities of this arrangement, what good would it do the potential purchaser? If the public information supports a solicited purchase, the customer will receive the same advice he would have received through his primary relationship, which is now restricted. That "protection" has no substance whatsoever.

Fourth, the Commission's proposal multiplies the number of persons who know material nonpublic information or know that the information exists, thus creating a poten-

tial enforcement horror. As pointed out in Shearson's Reply Brief [at 10], a no solicitation wire or the addition of a company to a restricted list constitutes an assurance that the firm now knows information which requires a modification of its present investment posture on the security. Even if the investment banker had absolutely no relationship with the issuer, it could nevertheless learn nonpublic information about the company; and the addition of that company to a restricted list would be the clearest indication that a new investment position on the company's securities was required. These facts plainly cannot be kept secret, and any policy which broadens the number of people with access to nonpublic information increases the risk that the information will be misused. This is hardly a policy the courts should espouse.

Last, the Commission's position rejects the often-stated views of the Commission and its former members, including two Chairmen. Both Chairman Casey and Chairman Cook advocated the predictable and enforceable solution offered by Shearson: urge the company to disclose and maintain the firm's present public posture until the nonpublic information is available to all investors. Casey, Speech Before the ABA, *BNA Sec. Reg. & L. Rptr.* at F-2 (August 16, 1972) and Interview with SEC Chairman, *Barron's* at 5 (April 9, 1973). The Commission's effort to distinguish these remarks [Commission Br. at 12, n. 14] is equivalent to saying that this case is different because the cab here is yellow. Both Chairmen, speaking of this problem in general, meant that the firm should not take a new position, change its publicly announced position, or alter its sales practices on a security until the information is public. And long before either of these men spoke for the Commission, that agency blessed Shearson's procedures in its own regulatory proceeding. *In the Matter of Shearson, Hammill & Co.*, Sec. Ex. Act Rel. 34-7743, CCH Fed. Sec. L. Rptr. ¶ 77,306 (1964-67 Transfer Binder) (at 82,528, n. 62) (November 12, 1965).

CONCLUSION

The Commission's policy would permit the execution of unsolicited orders, permit transactions in the securities of commercial loan customers by a bank's trust department, allow certain types of undefined solicitations, and sanction solicitation of purchases from unsolicited sales of blocks of stock. The Commission concedes that its policy might not be perfect. [Commission Br. at 13]. This is an understatement. To accommodate all the conflicting interests infringed by the "restricted list" procedure, a myriad of exceptions would have to be developed to that procedure, which is itself an exception to the general rule of equal access. On the other hand, Shearson's procedure would require no exception to the equality rule or artificial modifications of it. Business could always proceed "as usual" on both sides of the "wall". Different rules would not be necessary for different financial institutions, assuming, of course, that differentiation can be justified at all. Shearson's procedure would be perfectly workable for all types of business (brokerage firms, commercial banks, and insurance companies), for all types of securities accounts (regular accounts, discretionary accounts, and fiduciary accounts), and for all types of transactions (existing positions, new purchases, and sales). It should be approved by answering the certified question in the negative.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

- x

RENEE SLADE, :

Plaintiff-Appellee, :

-against- :

SHEARSON, HAMMILL & CO., INC., :

Defendant Third Party :
Plaintiff, Appellant,
:

-against-
: Docket No. 74-1537

NATIONAL BANK OF NORTH AMERICA,
:

Third-Party Defendant

- x

AFFIDAVIT OF SERVICE

EDWARD E. ODETTE, :

Plaintiff, Appellee, :

-against- :

SHEARSON, HAMMILL & CO., INC., :

Defendant Third Party :
Plaintiff, Appellant,
:

-against-
:

NATIONAL BANK OF NORTH AMERICA,
:

Third-Party Defendant
:

- x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

The undersigned, being duly sworn, deposes and says that he is over the age of 18 years and is not a party to the action.

That on the 4th day of November, 1974 he served the within Supplemental Memorandum upon

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the addresses having been designated by said attorneys for that purpose, by depositing two copies of same, securely enclosed in a postpaid properly addressed wrapper to each of said attorneys in an official depository under the exclusive care and custody of the United States Postal Service within the State of New York.

James R. Eller
James R. Eller

Sworn to before me this

4th day of November, 1974

ROBB A. COHEN
NOTARY PUBLIC, State of New York
No. 41-4526605
Qualified in Queens County
Certificate Filed in New York County
Commission Expires March 30, 1976